TRUSTEES AND SANCTIONS

Trustees and sanctions: Where angels fear to tread?

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It will not have escaped anyone's notice that there is a war in progress. Far from the battle still raging in Eastern Europe, that war, and the Western response to it by way of a stringent and wide-reaching package of coordinated economic sanctions, has been felt acutely in industries which, for many years, have serviced Russian clients (and those with a Russian connection) and their money.

It began with asset freezes in respect of so-called 'designated persons': individuals and corporations associated with the Russian state. Asset freezes are nothing new to the financial services sector. Most practitioners will be familiar with the no-consent regime applicable where there is a suspicion of money laundering which brings about a similar 'soft' freeze on funds.

What swiftly followed the asset freeze was a wide-ranging system of financial, trade, transportation and immigration sanctions designed effectively to cut off Russia (and a rapidly expanding list of people and entities with Russian connections) from major portions of the world economy.

The near-ceaseless expansion of the sanctions regime since the beginning of 2022 has proved to be one of the biggest logistical challenges the trust and fiduciary services sector has faced in recent years. It has been an almost constant challenge to keep pace with and adapt to the ever-expanding range of hitherto permitted economic activities involving Russians and Russian entities that have since become prohibited. That is to say nothing of the daily, sometimes hourly, changes to the list of so-called 'designated persons'.

EU response

The impact of financial sanctions on the fiduciary and corporate services sector was felt immediately with the asset freezes and prohibitions on making economic resources available to designated persons. However, it was the EU that first stepped up its measures

to directly target EU trust and company service providers (TCSPs) and prohibit them from conducting business with or for Russians. The EU sanctions marked a drastic shift in scope which, until April 2022, had been largely targeted at individuals and entities connected with the Russian government. The EU sanctions effectively target (if target is the correct term for such a broad measure) Russian nationals.

The measures, contained in EU Regulation 833/2014 (the EU Regulation), first introduced in early April, forbid the provision of registered office, business or administration services to trusts and 'similar structures' (including trusteeship or other fiduciary services) connected with Russian nationals. Article 5(m)(2) of the EU Regulation prohibits the provision of services as a nominee shareholder, director, secretary or a similar position for such persons

An unusual feature of the EU Regulation was how broad it was, applying to all EU persons, including nationals and entities incorporated or constituted under the law of any EU member state wherever they did business in the world. The EU Regulation also applied to all business done by EU and non-EU persons in whole or in part within the EU's territory. The reach of the EU Regulation is clearly extraterritorial. It would, for example, prevent an Irish or a Spanish citizen, living in Jersey (not an EU territory and which has not adopted the EU Regulation domestically), from participating in the provision of trust or administration services to a trust with a Russian connection. This has been a major headache for TCSPs operating outside the EU as, having already undertaken extensive due diligence on their existing client bases, they must also undertake a review of who among their staff might be prohibited from conducting trust and fiduciary services business which is perfectly lawful within the jurisdiction in which the TCSP operates.

The breadth of what was said to constitute a prohibited structure was extremely wide. A trust or 'similar structure' (no definition or examples are provided for such 'similar' legal arrangements in the Regulation) to which the provision of services was prohibited includes any trust or similar arrangement having as its settlor or a beneficiary:

> (a) a Russian national or a natural person residing in Russia (whether or not of Russian nationality);
> (b) legal persons, entities or bodies established in Russia;
> (c) legal persons, entities or bodies whose proprietary rights are directly or indirectly owned more than 50% by a natural or legal person, entity or body referred to in points (a) or (b);
> (d) legal persons, entities or bodies controlled by a natural or legal person, entity or body referred to in points (a), (b) or (c); or
> (e) a natural or legal person, entity or body acting on behalf or at the direction of a natural or legal person, entity or body referred to in points (a), (b), (c) or (d).

A limited exception, provided that a settlor or beneficiary would not count as falling within any of the above, would be if the settlor or beneficiary was a dual national of an EU member state or had temporary or permanent residency in an EU member state or in the EEA or Switzerland.

The nationality or residence of power holders such as a protector or 'any other natural persons exercising ultimate control over the trust' are not, it seems, relevant for the purposes of these restrictions.

The breadth and speed at which the EU Regulation was sought to be implemented (the original legislation provided only a month to comply, which has since been extended) is perhaps not surprising. Trusts are not a particularly important feature of many legal systems or economies within the EU. In most of the EU (with the obvious exception of Cyprus, whose finance industry has long been associated with Russian money), the sudden prohibition on the provision of trusts or company and fiduciary services was unlikely to cause many sleepless nights, particularly in major cities such as Paris, Berlin or Madrid. If something similar to the EU Regulation was to be attempted across the Channel, the position and reaction would likely be quite different.

UK response

The UK's sanction regime in response to Russia's invasion of Ukraine is contained in the Russia (Sanctions) (EU Exit) Regulations 2019 (the UK Regulations). The UK Regulations do not currently contain any equivalent of the targeted ban on the provision of trust and company services contained in the EU Regulation. However, on 29 June 2022 the Foreign Commonwealth & Development Office announced that:

> *… the UK government is also acting alongside international allies to introduce new measures that will prevent Russia from accessing UK trusts services.*

At the time of writing, no legislation had been introduced in relation to these proposed restrictions.

Practical difficulties in banning trustee services

Something evident from the two extensions the EU has now given to the long-stop implementation of the EU ban on trust and company service provision, is that trusteeship is not something that can be easily put down at will. It is trite law that a trust is not a free-standing legal entity independent of the trustee. The appointment of a new trustee is a fiduciary responsibility – a sole trustee cannot simply retire without a simultaneous replacement of itself with another trustee; for example, Art 19(1) Trusts (Jersey) Law 1984.

In a regulated industry, the office of trustee cannot simply be handed over to anyone willing to take it on. The outgoing trustee has a responsibility to the beneficiaries to appoint a trustee that is suitable. A trustee who retires in favour of a trustee who turns out to be uninsured, unregulated and based in an unregulated jurisdiction, who subsequently absconds with the trust fund, could face claims from beneficiaries that it has breached its fiduciary duties.

A trustee seeking to divest itself of a trust structure affected by the EU Regulation or the pending UK regime may face a more fundamental issue than finding a *suitable* trustee to replace them – they may struggle finding one at all. The number of reputable jurisdictions and TCSPs willing to accept appointment as trustee even involving a non-sanctioned Russian beneficiary or settlor is vanishingly small. It is not at all clear what a trustee who simply cannot retire is then expected to do.

Apart from any sanctions which are specific to the provision of trustee services, the outgoing trustee must also be extremely careful that in handing over the trust assets to a new service provider it is not unwittingly breaching other sanctions (eg by participating in an arrangement that could be interpreted as circumventing sanctions by making assets or economic resources available to a sanctioned person).

The combined effect of a constantly changing legal regime and the punitive criminal penalties for transgression (such as in Jersey's para 4(1) Sanctions and Asset-Freezing (Implementation of External Sanctions) (Jersey) Order 2021, which provides for a term of imprisonment for seven years and a fine for contravention of any of the prohibitions introduced into Jersey law from Parts 3-6A of the UK Regulations) has had a deeply chilling effect on the willingness of the compliance departments of regulated TCSPs to on-board any new structure with a Russian connection. The anecdotal evidence from finance professionals in Jersey is that financial institutions of all shapes and sizes are, rather than trying to navigate the constantly changing legislative landscape, simply divesting themselves of any business relationship that has even a tangential connection to Russia, sanctioned or not.

In an industry that is understandably risk averse, the effect of sanctions has achieved far more than a simple reading of the legislation would suggest. The major banks, whose liquidity underpins the provision of all offshore financial services from trust and fund administration to law firms, are extremely risk averse and highly vigilant in respect of any business being done that is even remotely connected with a designated person. It is most definitely not business as usual in the gaps between what the law prohibits.

The incidence of trusts in the UK (and in offshore jurisdictions that apply English trust law principles such as Jersey, Cayman and BVI) is far wider than first appears. It is still unclear what a ban on trusts in favour of Russian nationals would mean in practice. As well as the use of trusts (and TCSPs to administer them) as an express wealth structuring and planning tool, the use of trusts in English law exists in nearly all areas of commercial life, from security in commercial transactions to employee benefit trusts, pensions, escrow arrangements, nominee agreements, unit trusts, client money accounts, syndicated lending transactions and much else. These everyday arrangements involving trusts may not have occurred to the drafters of the EU Regulation but will undoubtedly have to be grappled with when the UK comes to implement a similar regime.

The offshore perspective

The effect of measures like the EU Regulation, if more widely implemented, would be felt most acutely in jurisdictions where trust and corporate services contribute a disproportionately large amount to the economy. Jersey enacted new legislation in 2019, the Sanctions and Asset-Freezing (Jersey) Law 2019 (SAFL), which provides for an overarching legislative framework to allow the easy adoption of UK and EU sanctions by way of secondary legislation. The approach in Jersey has been to mirror (with very minor derogations to accommodate local circumstances) the prohibitions set out in the UK Regulations.

Jersey follows the UK's list of designated persons. However, the exceptions and licensing regime applicable under the UK Regulations does not apply locally. If a licence or an

exception is sought, it must be applied for and obtained from Jersey's Minster of External Relations.

The Sanctions and Asset-Freezing (Implementation of External Sanctions) (Jersey) Order 2021 has been amended a total of 16 times since February 2022 to keep pace with the changing UK sanctions landscape. The legislation is nightmarishly complex (requiring a detailed understanding of the current state of the UK Regulations to understand what activity is or isn't permitted in Jersey at any point in time). It was introduced in considerable haste without very much guidance as to how it was supposed to be implemented by trustees. A curious omission from the Jersey legislation is that there is no provision in either the 2019 Law or the 2021 Order that authorises a TCSP to take its professional fees from funds that have been frozen by the sanctions.

The UK sanctions legislation has extraterritorial effect, applying to all UK persons (natural and legal) wherever located: see Sanctions and Anti-Money Laundering Act 2018, s21(2)-(3). The overarching UK legislation also reserves to the Crown in Council the power to add to the list of UK persons anybody incorporated in and of the Crown Dependencies or British Overseas Territories (BOTs). While there is alignment between the UK and Jersey sanctions, this does not present a difficulty. However, if Jersey were not to implement amendments to the UK Regulations banning the provision of trust and company services, that would give rise to a misalignment, creating the practical difficulty for all British citizens working in a TCSP with a prohibited structure. The UK government could also activate the power in s21(4) of the 2018 Act and in effect override the local Jersey legislation.

It remains to be seen whether Jersey, or the other offshore jurisdictions with close links to the UK, will implement a measure like the EU Regulation or a mirror UK equivalent. The legislative mechanism by which Jersey is able to adopt UK sanctions measures wholesale (rather than have to enact its own local measure every time the scope of sanctions change) is SAFL, which authorises Jersey's minister for external relations and financial services to give effect, either wholly or partly, to UK or EU sanctions measures by way of a local order. This would imply that Jersey does retain an element of legislative independence as to whether or not to implement a ban on the provision of trust and company services.

In practice it seems likely the offshore centres will come under considerable pressure to follow suit if the UK changes the scope of its sanctions regime to target trust and company service provision. No jurisdiction, many of which pride themselves for their well-developed anti-money laundering and compliance regimes, will wish to be painted as a 'safe harbour' for Russian money. For the reasons already addressed above, it is very difficult to see how (given the combined scope of the application of EU and UK sanctions to EU and UK citizens) there will be anyone left in places like Jersey able to administer structures that have a Russian connection.

The targeting of TCSPs brings into focus what the ultimate purpose behind sanctions measures is. Is it to send a message to Russians that 'we don't want your money here' (there are plenty of jurisdictions in the Far East and Middle East who will) or is it to enact economic pain on those who might bring pressure to bear on the Kremlin and its policies? If it is the latter, then the sudden, wholesale and effectively forced divestment of trusteeship is properly not in accordance with the purpose that should underpin the current sanctions regime.

Currently, funds or resources held in trust and company structures administered by Jersey entities that are associated with a designated person are subject to an asset freeze under the SAFL or are effectively frozen and cannot be accessed without an applicable ministerial licence or legislative exception. The wide scope of the asset freeze (and the fear of accidentally breaching its restrictions) has been very effective in cutting off designated persons from their funds and economic resources. If efforts are made to compel TCSPs to divest themselves of those frozen funds, it is not unimaginable that they could easily find their way into structures in other jurisdictions that are less exacting about the standards they apply and ultimately, perhaps, those resources may find their way back into the hands of those whom the sanctions regime was designed to target.

Another unforeseen consequence of wanting to appear on message and 'tough' on Russians that shelter their assets in offshore structures is that a rushed decision to divest may ultimately rebound on trustees. It is not unforeseeable that there will be a slew of claims against former trustees who, in anticipation of or in response to measures such as the EU Regulation (or a UK equivalent imposed on Jersey and the BOTs from London), rushed to divest themselves of trusteeships into the hands of trustees in less reputable and well-regulated jurisdictions in which the beneficiaries' interests may not be well looked after.

Even if the war in Ukraine ended tomorrow, it seems unlikely that the major Western economies will revert to the status quo before February 2022 for some time. The environment for Russian money is going to remain implacably hostile for the foreseeable future.

The rapid implementation of the asset freeze sanctions in the spring of 2022 was undoubtedly uncomfortable for those in the private wealth holding assets for sanctioned Russian clients. However, an asset freeze is a known and understandable concept, by analogy with the no-consent regime. The rapid expansion of sanctions beyond asset freezes into major interventions in the business model of certain industries by the wholesale banning of service provision, to an increasingly amorphous body of persons with a Russian connection, is of a different order of magnitude.

Such measures require close scrutiny and proper consultation with industry, to ensure that the underlying purpose behind them is not lost in the understandable desire to ratchet up enforcement against those who might bring the most pressure to bear upon the policies of the Russian government.

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